Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
Connect America Fund	)	WC Docket No. 10-90
A National Broadband Plan for Our Future	)	GN Docket No. 09-51
Establishing Just and Reasonable Rates for Local	)	WC Docket No. 07-135
Exchange Carriers	)	
High-Cost Universal Service Support	)	WC Docket No. 05-337
Developing a Unified Inter-carrier Compensation	)	CC Docket No. 01-92
Regime	)	
Federal-State Joint Board on Universal Service	)	CC Docket No. 96-45
Lifeline and Link-Up	)	WC Docket No. 03-109
Universal Service Reform – Mobility Fund	)	WT Docket No. 10-208

COMMENTS OF PARRISH, BLESSING & ASSOCIATES, INC.

January 18th, 2012

Parrish, Blessing & Associates, Inc. ("PBA") is an economic consulting firm with extensive experience in the development and calculation of weighted average cost of capital values. PBA's experience in such matters encompasses both traditional regulatory rate-making as well as the determination of forward-looking costs. The experts at PBA have represented telecommunications providers in a number of regulatory proceedings before the Federal Communications Commission ("FCC") and State regulatory commissions in Alaska, Arkansas, Georgia, Florida, Kansas, Kentucky, Missouri, Nebraska, New York, Ohio, Pennsylvania, Texas, U.S. Virgin Islands, Wisconsin, and Puerto Rico.

In the recent Intercarrier-Carrier Compensation and Universal Service Order ("Order"), the Commission initiated a represcription proceeding to update the allowed rate of return for non-price cap Local Exchange Carriers ("LECs"). Citing 47 CFR § 65.101, the Commission states that its rules "provide that a new prescription proceeding is satisfied if the monthly average yields on ten-year United States Treasury securities remain, for a consecutive six month period, at least 150 basis points above or below the average of the monthly average yields in effect for the consecutive six month period immediately prior to the effective date of the current prescription."[1] The Commission notes that, in fact, the average yield has been over 450 points lower over the past six months compared to the yield over the six months prior to the 1990 effective date of the current subscription.[2]

In the Order's accompanying Further Notice of Proposed Rulemaking ("FNPRM"), the Commission presents a preliminary analysis that it believes suggests that the authorized interstate rate of return should not exceed 9%.[3] Should the FCC adopt a 225 basis point reduction of the authorized return rate of return, LECs would see a 25% reduction in the return on capital component of unseparated loop costs resulting in a corresponding drop in USF funding. PBA and many of its small rate of return LEC clients are concerned that the Commission's preliminary conclusion calls for reductions in support while simultaneously requiring significant upgrades and build-outs of small LEC networks. Specifically, PBA believes that the Commission's conclusion that current market conditions indicate that the authorized return

[1] Order at 640
[2] Id.
[3] Order at 1057.

should be no greater than 9% errantly focuses on the reduction in the cost of U.S. Treasury debt while it ignores the ever increasing risks faced by small LECs. In addition, PBA does not believe that the current methodologies used to determine a cost of capital, as discussed by the Commission, will produce accurate results for small LECs. For these reasons, PBA does not believe the Commission should alter the current weighted average cost of capital ("WACC") of 11.25%.

Interest Rates Have Declined But That is Not the Whole Story

While it may be true that interest rates in general have declined, the cost of capital for small LECs is unlikely to have been materially impacted by this decline. This is because any decrease in the overall interest rates is likely to be more than offset by an increased cost of equity. As the Commission recognizes, small LECs operate in markets where switched access demand has eroded by roughly 50% over recent years[4] and where two of small LECs' major revenue streams, federal Universal Service Fund ("USF") support and intercarrier compensation ("ICC"), face significant uncertainty due to the reforms adopted by the Commission in the Order. Given the increase in risk associated with these access revenue decreases and the regulatory uncertainty introduced by the Order, equity investments are going to be more expensive for small LECs, offsetting any potential impact of a decrease in the cost of debt. In addition, given the current state of the financial markets and the fact that no suitable surrogate companies exist for small LECs, it is unlikely that the traditional tools used to estimate cost of equity will provide useful guidance on the small LECs' cost of capital. As a result, PBA recommends that the Commission table the represcription proceeding for the time being and focus on the sizable task of implementing the rest of the Order.

Recent Market Trends and the Order Increase the Level of Risk Faced by Small LECs

The Order further increased the risk faced by rate-of-return LECs that has been increasing steadily over recent years as intermodal competition has increased and overall access demand, as measured in access lines and access minutes of use, has decreased. Rate of return companies traditionally have competed in the local exchange and long distance markets. In 1992, these two markets accounted for 93% of telecommunications revenues, while competitive

[4] Order at 885-886, Figure 10.

local providers and wireless companies accounted for less than 6% of the market. However, in 2008 wireless and competitive providers accounted for 53% of the market revenues, which is more than an eightfold increase in market share over 16 years. During this same period, the share of the total telecommunications market represented by local exchange and long distance services declined by more than half to less than 42%.

In addition to these large scale market changes, the Order introduces additional uncertainty about small LECs' ability to recover costs and therefore repay both debt and equity investors in several respects. First and foremost, the Commission adds to the uncertainty regarding small LECs' ability to recover costs with its blanket assertion that companies are not necessarily entitled to recover investments made pursuant to Commission regulatory policy[5]. This assertion is not limited to investments which have been found to be not in the public interest through due process. Rather, the Commission asserts that it has the right to unilaterally change its policy without giving affected parties the opportunity to recover the costs of legitimate, good-faith investments made to meet universal service obligations the Commission itself established.

This is not simply a legal issue, but also a matter of sound public and economic policy. It is important to reiterate that many of the investments necessary to provide both broadband and voice services are depreciated and recovered over 10, 20, or more years. These investments have been made based upon the belief that a company will be given a reasonable opportunity to recover its investments. The Commission's change in its policies regarding companies' ability to recover legitimate good-faith investments introduces a substantial level of uncertainty into investment decisions for telecommunications companies and their investors. Given the Commission's policy change in this regard, investment decisions made in light of the Order will be made under the specter that other potential and unanticipated policy changes by the Commission that may curtail or eliminate the very funding mechanisms set forth in the Order to deploy broadband.

In addition, other changes to regulatory mechanisms as directed by the Order add substantially to the uncertainty faced by small LECs. The most significant change is the reduction and, ultimately, the elimination of interstate and state access charges with significant doubt about the

[5] Order at 221, et al

sources of adequate replacement of these revenue streams have been a major source of cost recovery for rate of return companies. In the face of the curtailment and elimination of these revenues, is the Order provides for only limited opportunity for cost recovery from other sources – namely, the Access Recovery Charge (ARC") and, for a select number of companies, potentially small increases in federal USF support[6].

As the Commission established, the ARC essentially is limited to a $2.50/month charge on residential customers and a $3.00/month charge on business customers. The ARC is further limited for companies that already have rebalanced intrastate access and local rates[7]. For these reasons, the ARC likely will not generate sufficient revenue for the recovery of existing investments, much less the increased investment required to extend broadband services to many of the customers served by rate of return companies.

Revenue uncertainty for small LECs is further exacerbated by the Commission's reductions in the availability of USF support. The Commission imposed an arbitrary cap on USF support at 4.5 billion over the next 6 years[8]. While this is the same level of funding that was estimated for fiscal year 2011, it is intended to support the added burden of building and operating broadband capable networks. In the event funding exceeds the $4.5 billion cap, the Commission states that it would adopt an action plan to reduce federal USF expenditures,[9] the likely source being additional reductions in federal USF distributions to carriers. This adds to the uncertainty regarding revenues for small LECs and is a further indication that companies cannot rely upon the current rules when making investment decisions because the Commission reserves the right to reduce universal service support in order to meet its arbitrary cap.

There are additional unknowns relative to the Order. The Commission concludes that depreciation and operating expense caps should be implemented in order to limit high cost loop

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[6] Order at 290

[7] The ARC can only be used by companies to the extent that a company's combined amount of residential flat local rates, federal Subscriber Line Charge ("SLC") inclusive of the ARC, mandatory extended area service charges, state SLC, replacement universal service contributions, state E911 charges and state TRS charges do not exceed $30.00/month. See Order at 852

[8] Order at 545

[9] Order at 563

support ("HCLS") and interstate common line support ("ICLS").[10] These caps will reduce universal service payments to numerous rate of return companies but the exact mechanism(s) by which such reductions will be determined remain subject to the Commission's FNPRM in this proceeding.[11] Consequently, companies are unable to quantify the potential financial impact of these caps, a situation that creates additional uncertainty and risk for companies and their investors.

Further, the Commission determined that these caps should be adjusted on an annual basis.[12] This will likely cause HCLS and ICLS support to fluctuate for a rate of return carrier, not necessarily because of a carrier's own actions, but due to the actions of other carriers with similar characteristics. As such, this will create ongoing uncertainty for rate of return carriers. While certain of the current universal service funding mechanisms exhibited this characteristic, these depreciation and operating expense caps will be applied in a significantly broader manner and therefore will greatly increase uncertainty for small LECs.

The Commission has also determined that rate of return companies are required to provide broadband services upon reasonable request within a reasonable amount of time.[13] However, no guidance has been provided regarding what constitutes either a reasonable request or a reasonable timeframe, thus introducing another level of uncertainty to small LECs.

Clearly, the Order results in an increase in the risk faced by rate of return LECs that will be factored into the decisions of any investor.

Methodologies for Determining the Cost of Capital are Not Necessarily Accurate for Small LEC's

In its Order, the Commission also sought comment on whether the formula for calculating the weighted average cost of capital currently found in its rules is appropriate.[14] The current rules

[10] Order at 214
[11] Order at 216
[12] Order at 214
[13] Order at 208
[14] Order at 1049.

call for the WACC to be calculated as the weighted average of a LEC's cost of debt and cost of equity.[15]

For background, the return earned by any firm must be adequate to service or compensate the suppliers of the capital used by the firm. This compensation, or the cost of capital, is required by the suppliers for postponing the use of the funds for other purposes and for exposing the invested capital to risk. Thus, the suppliers of debt funding are compensated through the cost of debt while the supplies of equity capital are compensated through the cost of equity. The cost of debt may be viewed as the interest paid on borrowed funds while the cost of equity is the expected return on investment paid to stockholders. Like all firms, the capital structure of small LECs is made up of some combination of debt and equity. In the case of small LECs, the percentage of equity in the capital structure is usually much higher than the percentage of debt.

In the FNPRM accompanying the Order, the Commission observed that fundamental changes in interest rates have occurred since 1990. The Commission specifically noted that since 1990 the three-month Treasury bill and the 10-year treasury constant maturity interest rate have declined significantly.[16] But, as described above, changes in the WACC are not limited to the level of U.S. Treasury interest rates. Since 1990 there have also been significant changes in both the telecommunications industry as well as in equity markets. When the prescribed interstate rate of return is updated it will be necessary to update the cost of debt and equity as well as the corresponding weights used to calculate rate of return LECs' WACC. The Commission has an obligation to set a rate of return that is "high enough to provide confidence in the financial integrity of the carriers, so that it can maintain its credit and attract capital" as well as "be commensurate with returns on investments in other enterprises having corresponding risks."[17]

This leads to the question of whether it would be possible to establish a WACC that accounts for all changes in the financial and telecommunications markets. Specifically, the question is whether the existing tools at our disposal are capable of estimating investor expectations regarding the cost of equity in today's unusual financial climate. PBA does not believe that the

[15] Debt and equity costs are weighted by the proportion of debt and equity in the capital structure respectively.
[16] Order at 1046.
[17] Order at 1045.

answer to that question is known. However, what is known is that the risk faced by small LECs is much greater than it was in 1990. The increase in risk, by definition, means that there is upward pressure on the cost of equity and therefore the WACC. That leads to another question of whether the increase in the cost of equity due to increased risk offsets or overwhelms the reduction in the cost of debt as observed through declining U.S. Treasury rates. At the end of the day, the Commission's conclusion that WACC should be reduced was based solely on observed changes in the U.S. Treasury rates. Without knowledge of all of the components of WACC, the Commission cannot determine that the WACC should be reduced.

Not only do the inputs to the current interstate rate of return need to be updated, but the rules themselves must be updated, specifically with regard to the cost of equity. The inputs and calculations used to estimate the weighted average cost of capital ("WACC") in Sections 65.301-305 of the Commission's rules may have been adequate for previous represcription proceedings, however, they are no longer appropriate in today's competitive marketplace. In recent years there have been substantial changes in the industry resulting in a significant change in the risks faced by the rate of return carriers. Many of these changes result from the increased competition, as discussed in the Commission's Memorandum and Order in the Verizon Virginia Arbitration Order.[18] Although some of the Commission's specific findings in Verizon Virginia proceeding may not be applicable to rate of return carriers, the scope of the marketplace changes identified in that proceeding is similar to that faced by rate of return LECs today and those findings are indicative of the type of changes that are required in the development of the WACC for an updated represcription.

As discussed above, the WACC is determined based on the costs for the individual components (typically equity, debt and preferred stock) and the weight for each of these components. Ideally, the cost of the individual components should be weighted by a firm's target or optimal capital structure. Unfortunately, it is not generally possible to observe the optimal or target capital structure a point in time and, as a result, the market value weights are used.[19] The weights, currently derived from *embedded* costs as required in section 65.304 of the Commission's rules,

[18] CC Docket Nos. 00-218, 00-25, Memorandum Opinion and Order (rel. August 29, 2003), paragraphs 58-104.
[19] 2011 Ibbotson SBBI Valuation Yearbook, page 14; Verizon Virginia Arbitration, paragraph 102 ("Verizon Virginia Arbitration")..

are not a reliable estimate of the optimal capital structure because they do not reflect the *current* conditions in the debt and equity capital markets. Furthermore, it is necessary that there be a match between the weights and returns used to calculate the WACC.[20] If the Commission believes that a change in the current WACC is required, a represcription investigation must also determine the appropriate weights to be used for the rate of return LECs.

Moreover, the cost components are a forward-looking concept and should be based on market values to ensure that these costs reflect the current opportunity costs of the funds invested in the company. Although the Commission's current rules recognize that formulas limited to historical data should not be used to develop the cost of equity, the Commission traditionally has based the cost of debt and preferred stock based on embedded (historical) costs. It may have been acceptable to use book values for these inputs in past periods with less competition and more stable capital markets, but given today's uncertainties, only current market yields will provide the true opportunity costs of the debt reflected in the WACC. That is because there will be a significant increase in the uncertainty in small LECs' ability to recover the investments made in the public interest under the Commission's proposed rules.[21] This increase in regulatory uncertainty combined with the increase in competition will materially impact the risk of its debt, a risk that is not reflected in the current embedded cost of debt. The use of embedded cost for preferred stock is even more problematic for the cost of debt since a portion of the cost of the preferred stock is reflected in the value of the investor's option to convert the debt to stock. The cost of this option will not be captured in the Commission's embedded costs calculation and therefore understates the opportunity cost of the preferred stock. As a result, any change in the WACC should include an investigation into the impact of the increase in risk on the cost of debt *and* preferred stock.

Calculating the cost of equity in today's environment is even more problematic than calculating the cost of debt. Not only is the cost of equity a forward-looking concept, it cannot be directly observed in the market as can the cost of debt. Consequently, it is necessary to use various methodologies to develop estimates of investors' current expectations. The Commission mentions a few possible methodologies in the FNPRM. One approach the Commission has relied

[20] Verizon Virginia Arbitration, Paragraph 103.
[21] Order at 221, et al

on in the past is the discounted cash flow ("DCF") methodology that replaces the problem of estimating the investor's expected return on equity with estimating investor's expected growth in earnings or dividends. Although a DCF model may have provided reliable estimates of the cost of equity in a time where telecommunications and capital markets were more stable, it has not been shown that this approach can continue to provide accurate estimates when demand for traditional service is declining rapidly, small telephone companies are rapidly evolving into small broadband companies and major revenue streams are in flux. The increase in the risk facing these companies has likely changed the profile of the companies' shareholders, and therefore, has changed how these companies are valued.

The FNPRM also discusses the use of the Capital Asset Pricing Model ("CAPM") to estimate the cost of equity. In the case of the CAPM, the problem of estimating investors' expected return is replaced with the need to estimate three inputs: 1) the risk-free rate of return: 2) the market premium; and 3) the beta (a measure of a security's sensitivity to the market as a whole). The CAPM also faces challenges providing a reliable estimate of the cost of equity given rapidly changing market conditions. The recent financial crises raised serious questions about the ability to derive reliable estimates of all three of these variables. First, the risk-free rate, as measured by the yield on Treasury securities, may have been driven down as investors fled the increased risks associated with the stock and corporate bond markets. Thus, a decrease in the risk-free rate may not reflect a lower underlying risk free-rate, rather it may be the result of investors' flight from risk and the Federal Reserve's policy of quantitative easing. Furthermore, Standard & Poor's downgrade of U.S. Treasury debt in 2011 raises questions as to whether the traditional measures of the risk-free debt are indeed risk-free.

Next, the long run market risk premium may also face distortion from the changes to the risk-free rate discussed above. Since the long run market risk premium is a function of the risk-free rate[22] any distortion in the risk-free rate can distort the market risk premium. The U.S. treasury constant maturity rates cited by the Commission[23] have reached historical lows during the last

[22] 2011 Ibbotson SBBI Valuation Yearbook, page 53.
[23] Order at 1046

three years.[24] Clearly this is not an indication of lower levels of risk during this period of volatility in capital markets. The long run risk premium was never meant to be used in a period that is considered to be an outlier of the long run trend.

Finally, the ability to calculate an appropriate beta may also have been compromised by the current market conditions. With the stock market collapse in 2008, estimates of the sensitivity of any single stock to the falling market can be artificially driven to one, distorting the estimated beta of an individual stock. The situation is further complicated by the dramatic changes that took place in the telecommunications industry during this time period making it very difficult to isolate the impact of the industry structure from the shocks to the global financial markets.

The ability of either of these traditional methodologies, DCF or CAPM, to provide reliable estimates of the cost of equity is further limited by the continuing consolidation of the industry and the growing importance of wireless services. To develop a reliable estimate of the cost of equity it is necessary to use firms (surrogates or peers) of similar risk. In the past, when the authorized rate of return was applicable to the largest and the smallest LECs alike, the Regional Bell Operating Companies were used as the peer group. Although this may have been appropriate at the time, the recent changes in the industry raise serious questions about this assumption. First and foremost, as price cap carriers, AT&T and Verizon and most other publicly traded LECs are no longer regulated as rate of return carriers and, therefore, will not be subject to any impact resulting from changing the authorized rate of return. As a result, it cannot be appropriate to base the change in the WACC on AT&T and Verizon data as the Commission has done in reaching its preliminary conclusion that the authorized return should not exceed 9%. This conclusion holds as well for the publicly traded midsize carriers cited in the Order as these companies are also price cap carriers. Second, less than half of the revenue of each of the two surviving RBOCs that the Commission used in its preliminary analysis[25] (AT&T and Verizon) is generated from its respective wireline segment.[26] The use of the appropriate peer group, which does not appear to exist anymore, is essential in developing a reliable cost of equity using the CAPM.

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[24] See 3-month and 10-Year Constant Maturity, *available at http://www.federalreserve.gov/releases/h15/data.htm*

[25] Order, paragraph 1057.

[26] See AT&T and Verizon, 2010 Annual Reports

A third complication arises from the fact that these traditional peers are so much larger than the companies to which the cost of equity will be applied. Modern finance theories state that there is a relationship between the size of the company and the required return. Many studies that have looked at the effect of firm size on return have found that investors expect smaller companies to have higher returns than larger ones.[27] As a result, the use of peer companies that are magnitudes larger than the rate of return companies will result in an understatement of the cost of equity and therefore the WACC. It is then necessary to use a peer group comparable in size as well as in other measures of risk to develop a reliable estimate of the cost of equity. Unfortunately, such a publically traded peer group does not necessarily exist. Also, the accuracy of existing methodologies that allow an adjustment to be made to the cost of equity to account for the increased risk of smaller firms is questionable given the out-of-trend financial market conditions we face today.[28]

In addition to the DCF and CAPM, there are several other widely used and effective methods to calculate the cost of equity such as the buildup method, the arbitrage pricing theory and the Fama-French three-factor model.[29] If the Commission intends to make any change to the WACC, the investigation should include consideration of these and other methods of estimating the cost of equity as well as the potential impact of the issues discussed above.

In conclusion, PBA believes that the Commission's preliminary determination that current market conditions indicate that the authorized return should be no greater than 9% focuses only on the reduction in the cost of U.S. Treasury debt and ignores the ever increasing risks small LECs face. In addition, PBA does not believe that the current methodologies used to determine a cost of capital as discussed by the Commission will produce accurate results for small LECs. For these reasons, the Commission should not alter the current WACC of 11.25% and the Commission should table the represcription proceeding for the time being and focus on the sizable task of implementing the other aspects of the Order.

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[27] 2011 Ibbotson SBBI Valuation Yearbook, page 83.
[28] Alternatively, methodologies exist that allow an adjustment to be made to the cost of equity to account for size differences. These methodologies add a "size premium" to the cost of equity of smaller companies to reflect this increase risk.
[29] 2011 Ibbotson SBBI Valuation Yearbook, page 27.

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Respectfully submitted,

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